Investment Strategy

Debt Ceiling Thoughts

Depending on what source is used, it is said that the United States raised its debt ceiling in some form at least 90 times in the 20th century and an additional 19 times since 2000. As a result of disagreements between the political parties over the debt ceiling, there have been government shutdowns (1995 and 1995-1996), a downgrade of the credit rating of the U.S. (2011), and the threat of automatic spending cuts in the form of the sequester (2013).

Once again, the debt ceiling has resulted in a collision between the two political parties with Republicans desiring greater fiscal restraint in the form of less spending and Democrats desiring a "clean" debt limit increase followed by a discussion around more tax revenue. In recent debt ceiling crises, these have been consistent themes. Policymakers continue to meet to find a solution as the so called 'x-date' is approaching. Treasury Secretary Janet Yellen recently stated that June 1st is the critical date, and most parties agree the first two weeks of June are the period when the situation becomes untenable. It is important to note that June 15 is a date when the Treasury will receive an infusion of additional tax revenue. And it is also important to note that despite the acrimony surrounding the negotiations historically, the U.S. has never failed to permanently make an interest or principal payment on the debt.

With a deadline looming in the next several weeks, a variety of measures have been suggested to stave off default. They range from dramatic (selling federal assets such as parklands or buildings or minting a $1 trillion coin) to potentially feasible (selling securities held in the government's trust funds and replacing them later or directing agencies to slow down submission of payments). None of these however, are more than a short-term stopgap.

In our opinion negotiations will continue with both sides adopting aggressive public stances and we believe there are three possible outcomes, with one having the highest probability by a wide margin:

1. Politicians adopt a "kick the can down the road" stance by temporarily suspending the debt limit until a later date, most likely in the fall. This outcome is not without precedent and was last used in 2019 when the debt limit was suspended for two years. We view this as the highest probability outcome at 95%+.
2. Forge an agreement that results in a 'permanent' increase in the debt ceiling. While this is a possibility, it seems unlikely in a compressed timeframe since it involves decisions based on deficit reduction and increased tax revenue if public comments from both sides are to be believed.

3. Allow the government to default on its obligations and negotiate after the fact. This option would be the worst outcome with potentially severe ramifications for the dollar, interest rates, financial markets, and the economy. Most people feel that this option is unthinkable, and like so many times previously a compromise will be reached at the 11th hour. With the political parties as far apart as they are, we feel this is a low probability outcome, but still a possibility.

To date the markets have been relatively sanguine about the possibility of a default, choosing to remain primarily focused on inflation and monetary policy. However, as the potential x-date draws closer with no resolution, focus on it should increase with negative ramification for stocks. The 2011 timeframe is probably a good comparison. There was a divided Congress and a Democratic president and a demand from Republicans that then President Obama negotiate over deficit reduction in exchange for a clean debt ceiling increase. A deal was reached two days before the Treasury estimated its borrowing authority would be breached. Financial markets suffered through a volatile period with the Dow Jones Industrial Average falling over 2,000 points (approximately 17%) that summer and 635 points in a single day. That period was characterized by high volatility and increased fear as evidenced by elevated readings of the CBOE Volatility Index and near bear market declines for stocks. Those factors have not manifested themselves in the current cycle to date, but the closer we draw to the x-date with no progress, the greater the possibility that the debt ceiling standoff will be a reason to sell stocks. ■